# No. 18,835

IN THE

# United States Court of Appeals

## For the Ninth Circuit

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MARIA TERESA CRUZ SEGUI, as next friend on behalf of DIGNA LUZ ORTIZ, an infant and HECTOR LUIS ORTIZ, an infant,

*Appellants,*

vs.

RUTH SNOW BURNS O'ROURKE and JOHN P. O'ROURKE,

*Appellees.*

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## APPELLANTS' REPLY BRIEF

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Appellees first argue in their brief that appellants are "collaterally estopped" from asserting the non-existence of the corporation Snow Lines, Inc. (hereinafter referred to as the corporation), and therefore the complaint must fail because the corporation was not joined as a party defendant in the action filed below.

They further assert that appellants are estopped from claiming that the corporation is but defendants' alter ego for the purpose of holding defendants per-

sonally liable upon the judgment against the corporation. Appellees refer to appellants' attempt to "make out a claim under § 2202" of the Puerto Rico Corporations Code and to appellants' "claim based on § 2202" (Appellees' Brief, p. 8).

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1. **APPELLANTS DO NOT ASSERT ANY "CLAIM UNDER § 2202"; SECTION 2202 IS RATHER A STATUTE WHICH SETS FORTH THE CONDITIONS WHICH MUST BE MET IN BRINGING AN ACTION UNDER PUERTO RICAN LAW AGAINST DIRECTORS OR STOCKHOLDERS OF A CORPORATION WHEN THEY ARE LIABLE TO PAY THE DEBTS OF THE CORPORATION.**

The liability of the appellees to pay the judgment debt of the corporation is based not upon section 2202, which itself imposes no such liability, but upon sections 1521 and 1804 of the Puerto Rico Law of Private Corporations, set out in Appellants' Opening Brief at pages 20 and 22, and upon the common law.

Appellees have argued in their brief at length (pages 3-6, 8-9, 16-17) that the corporation is an indispensable party defendant under section 2202, the non-joinder of which in the action deprives the District Court of jurisdiction.

Appellants submit that appellees have improperly raised for the first time on this appeal the objection that the corporation is an indispensable party to the action. This point was not asserted in the Court below and was not before that Court for consideration in the rendering of its decision on appellees' motion

below. The argument is properly raised on further motion under Rule 19 of the Federal Rules of Civil Procedure, 28 U.S.C.A., in the trial Court and, if well taken by that Court, appellants should have the opportunity to amend their complaint to join the corporation.

Appellees asserted in the Court below (Tr. 18-19), and argue further in their brief on appeal (pages 2-4, 7, 17) only that the joinder of the corporation as a party defendant destroyed the jurisdiction of the District Court as based on diversity of citizenship, under 28 U.S.C.A. § 1332 (Appellees' Brief, p. 2). Appellees below in fact argued that the joinder of the corporation destroyed diversity *though they need not have been joined* (Tr. 19).

When it was made clear to appellants that the Court below intended to dismiss on the basis of non-diversity, and since they were not faced with the argument that the corporation was an indispensable party, appellants moved to dismiss the corporation as a party defendant (Tr. 54-55), though the appellants had argued their position below that their joinder as a nominal or formal party did not in any event destroy diversity jurisdiction in the District Court (Tr. 52-53).

Section 2202, Chapter 112, Title 14, Private Corporations, 3A Laws of Puerto Rico, has been set forth by Appellants in their Opening Brief at page 10 and appears as Footnote 3 in Appellees' Brief at page 4. Section 2202(a) provides that an action to enforce the liability of directors or stockholders of a corpo-

ration to pay the debts of the corporation "shall be a class action for the benefit of all creditors to which the corporation if in existence shall be a party."

Section 2202 does not require that the corporation shall be joined as a party *defendant*. It would be better argued, particularly in view of the fact that directors' liability under section 1521 of the Corporation law is imposed in favor of both the corporation and its creditors, that the corporation might be more properly joined as a party *plaintiff*, and thus, even if joined as a nominal party defendant because of the impossibility of obtaining its consent to such joinder as a plaintiff, such joinder as a nominal party defendant would not destroy diversity.

Furthermore, the appellants could not in any event be estopped by a finding that the corporation was in existence in December 1959 from asserting that the corporation no longer had any valid existence in December 1962. The complaint below, filed December 3, 1962, alleges that the corporation "has for at least three years next preceeding the filing of this complaint" had no known place of business or named agent and had failed to keep its books or file annual reports as required by the laws of Puerto Rico (Tr. 2, 3). It was further alleged in the complaint that on a date *subsequent* to the entering of the Judgment of December 3, 1959, the appellees conveyed the corporation's sole asset and distributed between themselves the proceeds from said conveyance, thereby rendering the corporation insolvent and unable to pay its judgment debt to appellants (Tr. 5).

Appellants subsequently learned and stated in their memorandum below (Tr. 46) and in their Opening Brief on Appeal at page 3, that the corporation disposed of its sole asset in April 1954. The appellants have not stated when the unlawful distribution of the proceeds from that sale was made as they do not have knowledge of when this act, which constituted the ultimate fraud alleged and incurred the statutory liability of appellees as directors and shareholders of the corporation, was performed by the appellees.

Even if appellants were estopped from denying the existence of the corporation prior to December 3, 1959, the Judgment rendered that date cannot be binding as to or even evidence of its continued existence subsequent to that date, nor in any way does the Judgment estop the appellants from asserting the de facto dissolution of the corporation and denying the existence of the corporation which renders unnecessary under section 2202 its joinder as a party in this action filed December 3, 1962.

The naming of the corporation as a party to the action is of course unnecessary to the maintenance of the action on the common law theory of appellees' personal liability for the corporation's judgment debt. No relief is sought in the action against the corporation and it is in no way a real party in interest in the action.

2. APPELLANTS' ACTION AS BASED UPON APPELLEES' STATUTORY LIABILITY UNDER PUERTO RICAN LAW WAS FILED IN THE COURT BELOW WITHIN THE APPROPRIATE PERIOD OF LIMITATIONS.

Chapter 41 of Title 32, Code of Civil Procedure, 8 Laws of Puerto Rico Annotated, sets forth the statutory provisions relating to the time of commencing civil actions. Section 261 of that chapter provides as follows:

> "§ 261. This part does not affect actions against directors or stockholders of a corporation, to recover a penalty or forfeiture imposed, or to enforce a liability created by law; but such action must be brought *within three years after the discovery by the aggrieved party of the facts upon which the penalty or forfeiture attached or the liability was created.*" (Emphasis added.)

We find no Puerto Rican cases under this section, but the statutory history states that the above-quoted provision was derived from section 359 of the California Code of Civil Procedure, the language of which is essentially identical to that of section 261 above and under which there have been numerous Court decisions.

It has been well established that the term "created by law," as used in this section is confined and restricted to liability existing by virtue of express statute and does not include or extend to actions arising under common law.

> *Southern Counties Thrift Co. v. Rairdon*, 47 Cal.App.2d 770, 118 P.2d 828 (1941);
>
> *Coombes v. Getz*, 217 Cal. 320, 18 P.2d 939 (1933).

This three-year statute clearly therefore does not bar the action as based upon the appellees' common law liability, as set forth in Appellants' Opening Brief at pages 17-18, and as established under the law of Puerto Rico as discussed below.

Nor does this statute bar appellants' action to enforce the statutory liability of appellees as directors or shareholders of the corporation imposed under sections 1521 and 1804(e) of the Puerto Rican Law of Private Corporations, Title 14, 3A Laws of Puerto Rico (1962).

The "facts upon which . . . the liability was created" under these sections were, it is true, the sale of the corporation's sole asset, which it is now known occurred in 1954, and the unlawful distribution of the corporate assets between the appellees, which occurred at some date still unknown to appellants. Neither of these sets of facts was *discovered* by appellants, however, until they had obtained a judgment against the corporation, execution upon which was returned unsatisfied due to the then-discovered insolvency of the corporation, caused by the subsequently discovered aforesaid acts of appellees.

This action was thereupon instituted by appellants in the District Court below within the prescribed three years after their discovery of the facts upon which the liability asserted was created.

The fact that appellants have admitted in their statement in brief on appeal that they now have knowledge, obtained subsequent to the time the complaint was filed in this action alleging the sale of the corporate asset subsequent to the date of the

judgment of December 3, 1959, against the corporation, that the conveyance was made in 1954 is, moreover, in no way relevant to their claim against appellees for the wrongful payment of dividends or for the unlawful reduction of the corporation's capital. The wrongful act of the appellees by which they incur statutory liability as directors and shareholders under both sections 1521 and 1804 is, again, their distribution of the proceeds of the sale between them, i.e., their conversion to their own use of the money belonging to the corporation. Appellants have not yet discovered when such distribution was made.

The facts now of record do not establish that this action is barred by section 261 of the Puerto Rico Civil Code or by section 359 of the California Civil Code. Again, appellants still do not know when the distribution of the corporate assets, the proceeds from the sale of the M/V LEDA I, was made by appellees. These facts remain for discovery by the appellants, and it is for the pleading as an affirmative defense by appellees and determination by the trial Court if the unlawful dividend was paid more than six years preceding the filing of the complaint below, and thus the period of liability created by section 1521 of the Puerto Rico Corporation Law has expired, or if the aggrieved parties, the appellants, discovered the facts upon which the statutory liability of appellees as directors or stockholders of the corporation was created more than three years prior to December 3, 1962.

*Cf., Hospelhorn v. Newhoff*, 43 Cal.App.2d 678, 111 P.2d 688 (1941).

### 3. APPELLEES MAY BE HELD LIABLE FOR THE JUDGMENT DEBT OF THE CORPORATION WHEN THE CORPORATION IS MERELY THEIR "ALTER EGO".

This is not, as appellees insistently maintain, essentially or excusively a suit "upon the judgment itself" (Appellees' Brief, p. 10). This is an action in which appellants, as creditors of the corporation who happen to be *judgment* creditors of the corporation, seek to recover the amount of a judgment *debt* owed by the corporation to appellants and which the corporation is unable to satisfy due to the wrongful conduct of appellees and for which they are liable by virtue of statutory provisions and common law principles.

Nor is this an action against the appellees for the corporate tort which resulted in the wrongful death of appellants' father. Appellees are liable for their wrongful acts which rendered the corporation insolvent and unable to pay its judgment debt. They are therefore liable to appellants as judgment creditors under sections 1521 and 1804 of the Puerto Rico Corporation Law (Appellants' Opening Brief, pp. 20-23) and under the common law liability of directors for the wrongful distribution of assets rendering the corporation insolvent or of directors and shareholders who have received such assets impressed with a trust in favor of creditors (Appellants' Opening Brief, pp. 17-18).

Appellants do advance as an alternate theory, in support of their contention that it does not appear to a certainty that the appellants would not be entitled to relief under any set of facts which could be proved in support of the claim pleaded and therefore the

complaint should not have been dismissed (Appellants' Opening Brief, pp. 12, 14), that the corporate entity of Snow Lines, Inc., should be disregarded and appellees should be held personally liable *on the judgment* against the corporation (Appellants' Opening Brief, pp. 25-28).

Appellees have ignored appellants' citation at page 26-28 of their Opening Brief of the case of *Cruz v. Ramirez,* 75 P.R.R. 889, 895-96 (1954), in which the Supreme Court of Puerto Rico held that a complaint seeking to enforce a judgment debt of a corporation against individual stockholders, on the theory that the corporation was the mere "alter ego" of those stockholders, was not subject to dismissal but stated sufficient facts to furnish the trial Court a basis for deciding whether the circumstances of the particular case warranted the application of the "alter ego" rule in enforcing the judgment against the stockholders.

The only authority cited in appellees' argument for the proposition that individuals may not be held liable for judgments against their corporate alter egos is *Minton v. Cavaney,* 56 Cal.2d 576, 364 P.2d 473 (1961). Appellants maintain that this case stands, rather, by implication, for the opposite proposition. Plaintiffs in that action sought to hold the defendant personally liable for a judgment recovered against a corporation for the wrongful death of plaintiffs' daughter. The defendant died while the action was pending and prior to trial and his executrix was substituted as defendant. In its opinion the California

Supreme Court recited the various situations which are an abuse of the corporate privilege and to which the "alter ego" or "disregard of the corporate entity" theory will therefore apply. These included situations in which the owners of the corporation treat the assets of the corporation as their own and add or withdraw capital from the corporation at will, and situations in which they provide inadequate capitalization and participate actively in the conduct of corporate affairs. 364 P.2d at 475, and authorities cited therein.

The Court characterized the action as one "to hold defendant . . . personally liable for the judgment against . . . [the corporation]." 364 P.2d at 474, 476. The Court did not hold that such an action could not be maintained or that the "alter ego" doctrine would not apply, but held merely that a corporate director would not be held personally liable upon a judgment against the corporation for negligence, when the defendant director had neither been a party to the action against the corporation nor had he controlled the litigation leading to the judgment against the corporation, without an opportunity to relitigate the issues of the corporation's negligence and the amount of damages, and in that case the plaintiff had failed to allege or present any evidence on the issue of the corporation's negligence or the amount of damages. 364 P.2d at 476.

In the complaint filed below in this action, it is alleged that "by reason of the negligence" of the corporation, the plaintiff's father suffered injuries which resulted in his death, as a result of which "plaintiffs

. . . suffered damages in the sum of Twenty Thousand Dollars ($20,000)" (Tr. 3), and further evidence would be presented to support those allegations of the corporation's negligence and the amount of damages. Appellees would have the opportunity to assert in this action any defense against those allegations that they might have raised in the earlier action.

Section 2202(b), Chapter 112, Title 14, Private Corporations, 3A Laws of Puerto Rico (1962), expressly provides that when a suit is brought against an officer, director or shareholder of a corporation for a debt or liability of the corporation and after judgment has been obtained therefor against the corporation, "any such officer, director or stockholder may set up any defense which the corporation might have asserted against such debt or liability."

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4. **APPELLANTS ARE NOT COLLATERALLY ESTOPPED FROM ASSERTING THAT THE CORPORATION IS THE ALTER EGO OF THE APPELLEES.**

In *Minton v. Cavaney, supra,* furthermore, the same plaintiffs who sought to enforce personal liability upon the defendant director for the judgment against the corporation had brought the prior action against the corporation, asserting that the corporation was in existence and duly incorporated in California. The corporation, which had operated a pool in which the plaintiffs' child had drowned, was specifically found by the Supreme Court to have been duly incorporated in California and its existence had never been for-

mally dissolved. The plaintiffs were not, however, "collaterally estopped" from asserting that the corporation was defendant's "alter ego" for purposes of holding him personally liable for the corporate judgment debt. The Court held, rather, that the judgment against the corporation in no way barred the action against the individual defendant based entirely upon the "alter ego" doctrine. 364 P.2d at 476. Nor do we find any other authority in support of the theory of collateral estoppel under such circumstances as advanced by the appellees in their brief at pages 5, 11-12.

Moreover, as pointed out above, any such rule of collateral estoppel would bar only the appellants' denial of the corporation's valid existence prior to the date of the Judgment of December 3, 1959, and not a denial of its existence subsequent to that time when it is alleged the appellees' personal liability arose.

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5. THE COMMON LAW THEORY OF LIABILITY OF DIRECTORS AND SHAREHOLDERS OF A CORPORATION TO CREDITORS FOR THE DEBTS OF THE CORPORATION IS RECOGNIZED BY THE SUPREME COURT OF PUERTO RICO.

The common law theory of liability of directors and shareholders who have received a distribution of corporate assets to creditors and all others holding claims, asserted by appellants in their Opening Brief at page 18, has been expressly enunciated, contrary to appellees' contention at pages 13-14 of their brief, by the Supreme Court of Puerto Rico in the case of

*Cruz v. Ramirez*, 75 P.R.R. 889, 895 (1954), as follows:

> "The creditors of a corporation may personally sue the stockholders or the directors who are constituted trustees in liquidation after dissolution, with respect to the property of the corporation held by those stockholders or trustees, and if the latter dispose of, or sell that property to the prejudice of creditors, they may incur a personal liability to those creditors. Fletcher, *Cyclopedia of the Law of Private Corporations*, Vol. 16, § 8161, p. 922 *et seq.; Koch v. U.S.*, 138 F.2d 850; *Hutton v. Commissioner of Internal Revenue*, 59 F.2d 66, particularly if the corporation is insolvent after dissolution. *Cf.* 13 Am. Jur. 991. The relevant rule is to the effect that such property should be considered as existing for the benefit, in part, of the creditors, and such stockholders or trustees receive it, in part, for the benefit of the creditors, and therefore they may not dispose of such property to the creditors' prejudice. Regarding the 'trust-fund' rule as respects such property, see 13 Am.Jur. 1197.
>
> "It is alleged in the complaint before us that the defendants have sold the property of the corporation and have rendered it insolvent to the prejudice of plaintiffs as creditors, 'for the sole and deliberate purpose of defrauding the plaintiffs as creditors.' Such allegation is sufficient to hold defendants personally liable, in view of the rules set forth above."

6. APPELLANTS' ACTION AS BASED UPON COMMON LAW DOCTRINES WAS FILED IN THE COURT BELOW WITHIN THE APPROPRIATE PERIOD OF LIMITATIONS.

It was pointed out above that section 261 of the Pureto Rico Code of Civil Procedure does not bar the appellants' action under the statutory or common law theories of appellees' liability advanced by appellants.

Appellees argue at pages 14-15 of their brief that a cause of action based upon the common law doctrine, as clearly accepted by the Supreme Court of Puerto Rico in *Cruz v. Ramirez, supra*, would be barred by the statute of limitations, citing as the applicable statute section 5298 of the Puerto Rico Civil Code. This section provides a one-year limitation period for actions arising under section 5141 of the Civil Code, which reads as follows:

> "§ 5141. A person who by an act or omission causes damage to another when there is fault or negligence shall be obliged to repair the damage so done." Chapter 393, Title 31, 8 Laws of Puerto Rico (1955).

Appellees further assert that the action would also be prescribed under section 361 of the California Code of Civil Procedure which provides that a cause of action is barred in California when it would be barred by the statute of limitations of the state or foreign country where the cause of action arose.

Appellants concede that appellees have chosen that statutory provision in section 5141 which apparently encompasses the fraudulent conduct of appellees and

that an action against them might be barred under section 5298 of the Puerto Rico Civil Code were it not that the prescription statute was tolled and has not run against the appellants.

Appellants alleged in their memorandum submitted to the Court below (Tr. 47) and in their Opening Brief at page 4 that appellees left the Commonwealth of Puerto Rico in 1954. It is unknown to appellants and therefore subject to discovery in this action or affirmative plea by appellees, whether appellees have ever returned to the Commonwealth of Puerto Rico or for what periods of time they have done so.

Section 253 of the Puerto Rico Code of Civil Procedure, Chapter 41, Title 32, 8 Laws of Puerto Rico (1955) provides as follows:

> "If when the cause of action accrues against a person, he is out of the Commonwealth of Puerto Rico, the action may be commenced within the term herein limited after his return to said Commonwealth, and if, after the cause of action accrues, he departs from said Commonwealth, the time of his absence is not part of the time limited for the commencement of the action."

Section 254 of the Puerto Rico Code of Civil Procedure provides in relevant part as follows:

> "§ 254. If a person entitled to bring an action, other than for the recovery of real property, be at the time the cause of action accrued, either:
>
> 1. Within the age of majority; . . .
>
> the time of such disability is not a part of the time limited for the commencement of the action."

The above-quoted section 254 is derived from and its language is essentially identical to section 352 of the California Code of Civil Procedure.

The action insofar as it is based upon the common law is therefore not barred by the Puerto Rican prescription statute cited by appellees or under section 361 of the California Code of Civil Procedure.

Nor is the action barred by section 338 of the California Code of Civil Procedure which imposes a three-year period of limitation for an action for relief on the ground of fraud. This statute is likewise tolled by section 352 of the California Code of Civil Procedure during the minority of the appellants.

The complaint filed below affirmatively shows that appellants, plaintiffs below, are minors (Tr. 1, 3) and the suit was brought on their behalf by their next friend, and it is clear that the cause of action accrued to the minor appellants themselves and that therefore the statute of limitations was tolled during their minority.

*Aronson v. Bank of America N.T. & S.A.*, 42 Cal.App.2d 710, 109 P.2d 1001, 1007 (1941).

Section 338 provides, moreover, that an action subject to the three year limitation period for actions based on fraud is not "deemed to have accrued until the discovery, by the aggrieved party, of the facts constituting the fraud."

As appellants have alleged above, the fraudulent conduct of appellees was not discovered by them until after they had obtained the judgment against the

corporation, execution on which was returned unsatisfied because of the corporation's insolvency. This action was, therefore, instituted within the three year limitation period prescribed by section 338 of the California Code of Civil Procedure.

Under appellants' theory that the appellees should be held personally liable for the judgment against their corporate "alter ego," the applicable statute of limitations is section 337.5 of the California Code of Civil Procedure, prescribing a ten year period for actions upon judgments or decrees of any Court of the United States. This action was instituted within three years of the time their action accrued based upon the judgment rendered December 3, 1959, by the District Court of Puerto Rico.

Dated, Oakland, California,
January 17, 1964.

Respectfully submitted,
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